(4)

No. 90-1491

IN THE

Supreme Court of the United States

OCTOBER TERM, 1991

UNION BANK,

Petitioner,

v.

HERBERT WOLAS, CHAPTER 7 TRUSTEE FOR THE ESTATE OF ZZZZ BEST CO., INC.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF OF PETITIONER

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QUESTIONS PRESENTED

1. Bankruptcy Code § 547(c)(2) protects otherwise preferential payments from recovery by a trustee in bankruptcy if the payments are (a) made on a debt incurred in the ordinary course of business of the debtor and the creditor, (b) made in the ordinary course of business, and (c) made in accordance with ordinary business terms. Is there an unwritten limitation under Bankruptcy Code § 547(c)(2) by which the statute only protects payments on short-term trade debt from recovery; or, should Bankruptcy Code § 547(c)(2) be applied in accordance with its plain meaning to protect all debts incurred in the ordinary course of business, whether a debt is long-term or short-term, because literal application of the statute is not demonstrably at odds with the intention of the drafters?

If the Court concludes that § 547(c)(2) draws a distinction between payments on short-term debt, which would be protected, and payments received on long-term debt, which would not be, then the following additional question is presented for determination:

2. Did the Ninth Circuit err by failing to define "long-term" debt in accordance with generally accepted accounting principles, income tax rules, and the general course of dealing in business transactions, thereby denying commercial lenders legal certainty in the application of Bankruptcy Code § 547(c)(2)?

LIST OF PARTIES

The list of parties submitted in the Petition for Writ of Certiorari remains an accurate representation of the information required by the Court regarding the parties to this proceeding.

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BRIEF OF PETITIONER

OPINIONS BELOW

On December 28, 1990, the Court of Appeals for the Ninth Circuit issued its opinion reversing the order of the district court that had affirmed the bankruptcy court's judgment in favor of Petitioner, Union Bank. The opinion is reported at 921 F.2d 968 and reprinted as Appendix A to the Petition for Writ of Certiorari.

On August 8, 1989, the District Court for the Central District of California entered its Order Affirming Judgment, affirming the summary judgment of the bankruptcy

court granted in favor of the Bank. The district court order was appealed by the Respondent to the court of appeals. The district court order was not published and is reprinted as Appendix B to the Petition for Writ of Certiorari.

The judgment of the Bankruptcy Court for the Central District of California which granted summary judgment in favor of the Petitioner, from which appeal was taken by the Respondent to the district court, was not published. The bankruptcy court's Judgment on First Cause of Action; Adjudication of Controversies on Fourth Claim for Relief, entered August 23, 1988, and Findings of Fact and Conclusions of Law related thereto, are reprinted in Appendices C and D, respectively, to the Petition for Writ of Certiorari.

JURISDICTION

The judgment of the Court of Appeals for the Ninth Circuit was entered on December 28, 1990, reversing the order in favor of the Petitioner entered by the district court that affirmed the judgment of the bankruptcy court. Union Bank filed its Petition for Writ of Certiorari with this Court on March 26, 1991, pursuant to 28 U.S.C. § 1254(1), and the Petition for Writ of Certiorari was granted by this Court on May 13, 1991.

STATUTES INVOLVED

This case involves a lawsuit filed by Respondent, a bankruptcy trustee, to recover from Union Bank certain monthly interest payments and a small monthly loan fee as preferential transfers under § 547(b) of the Bankruptcy Code, Title 11 of the United States Code. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 1549. Section 547(b) provides:

> Except as provided in subsection (c) of this section, the trustee may avoid any transfer of an interest of the debtor in property—

> (1) to or for the benefit of a creditor;
>
> (2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
>
> (3) made while the debtor was insolvent;
>
> (4) made—
>
> (A) on or within 90 days before the date of the filing of the petition; or
>
> (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
>
> (5) that enables such creditor to receive more than such creditor would have received if—
>
> (A) the case were a case under chapter 7 of this title;
>
> (B) the transfer had not been made; and
>
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

There are exceptions to the trustee's ability to avoid certain transfers under 11 U.S.C. § 547 that are set forth in § 547(c). The exception upon which the Petitioner has relied to defend against the trustee's preference action is § 547(c)(2), which provides as follows:

> The trustee may not avoid under this section a transfer—
>
> . . . .
>
> (2) to the extent that such transfer was—
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms.

STATEMENT OF THE CASE

The preference statute allows a trustee to recover from a creditor payments made to the creditor within 90 days of bankruptcy on account of an antecedent debt if by retaining the payments the creditor would receive more than it would have received in a Chapter 7 liquidation. 11 U.S.C. § 547(b).[1] However, even if the trustee establishes each of the elements of a preferential transfer under § 547(b), the Bankruptcy Code exempts certain preferential transfers from recovery by the estate.

The preference recovery exception at issue in this case is the provision that exempts "ordinary course of business" payments from avoidance. The creditor must demonstrate that (a) the debt was incurred in the ordinary course of the debtor's and the creditor's business or financial affairs, (b) the payment was made in the ordinary course of business or financial affairs of the debtor and the creditor, and (c) the payment was made in accordance with ordinary business terms.

On December 16, 1986, the Bank and ZZZZ Best (the "debtor") entered into a revolving credit agreement pursuant to which the Bank agreed to provide the debtor with a revolving line of credit in the sum of $7 million. Appendix D to Petition, p. 12a, Findings of Fact para. 1. The Bank's lending relationship with the debtor was further evidenced by a promissory note dated December 17, 1986. App. D to Pet., p. 12a, Findings of Fact para. 2.

The loan documents required the debtor to make monthly interest payments on the unpaid principal balance outstanding on the line and a small monthly loan commitment fee calculated according to the amount of any unused credit available under the line. App. D to Pet., p. 12a, Findings of Fact paras. 1 and 2. The debtor also executed an "Authorization for Disbursement" that authorized the Bank to charge the debtor's checking account automatically at the end of the month for the monthly interest and commitment fees required to be paid under the line of credit. App. D to Pet., p. 12a, Findings of Fact para. 3.

[1] If the recipient or beneficiary of the payment is an "insider," payments within one year of bankruptcy are recoverable as preferences. 11 U.S.C. §§ 101(31) and 547(b)(4)(B); *Levit v. Ingersoll Rand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1986).

The debtor timely made the routine monthly interest payments and paid the monthly loan fees, when applicable, until July 1987. App. D to Pet., pp. 13a-14a, Findings of Fact para. 6, Conclusions of Law paras. 4-6, inclusive. These payments included (a) a loan fee in the sum of $2,511.38 made on April 10, 1987; (b) a monthly interest payment in the sum of $48,951.39 made on April 30, 1987; and (c) a monthly interest payment in the sum of $52,869.44 made on June 1, 1987.

On July 8, 1987, the debtor filed its voluntary petition under Chapter 7 of the Bankruptcy Code. App. D to Pet., p. 13a, Findings of Fact para. 7. Herbert Wolas, the Respondent herein, was appointed as the Chapter 7 trustee of the debtor's estate. The trustee filed a preference action against the Bank to recover the monthly loan payments referenced above.

The Bank filed a motion for summary judgment asserting that even if all the payments were preferential under § 547(b), the payments were not recoverable by the estate because they were protected by the ordinary course of business exception of § 547(c)(2). The trustee contended that, as a matter of law, the payments were recoverable by the estate because: (a) the ordinary course of business exception does not apply to "long-term" debt or non-trade debt; and (b) the ordinary course of business exception does not apply in this case because the debtor was involved in a Ponzi[2] type of scheme.

[2] The Ninth Circuit defines a Ponzi scheme as "any sort of fraudulent arrangement that uses later acquired funds or products to

The bankruptcy court rejected both of the trustee's contentions, ruling that § 547(c)(2) applied to all debt, not just trade debt, and that the loan in question was incurred by the debtor and made by the Bank in the ordinary course of the parties' businesses. For the purposes of examining the trustee's cross-motion for summary judgment, the court considered the alleged facts that the debtor engaged in fraudulent business activities[3] and the Ponzi scheme line of cases in which courts have required equality of distribution among a defrauded class of similarly situated investors. However, the court ruled that the Ponzi scheme cases were not applicable to the Bank in this case since the Bank received the payments in question as a commercial lender in a routine loan transaction, was not an investor, and had no claim to any extraordinary profits such as the investor in a Ponzi scheme would typically have. App. D to Pet., pp. 14a-15a, Conclusions of Law paras. 9 and 10.

On appeal from the district court, the Ninth Circuit reversed, holding that as a matter of law, under its recent ruling in *Matter of CHG Int'l, Inc. (CHG Int'l, Inc. v. Barclays Bank)*, 897 F.2d 1479 (9th Cir. 1990), payments on long-term debt are not protected from recovery under § 547(c)(2).[4] The Ninth Circuit further ruled that because the debt held to be long-term in *CHG* had a term of seven months and the debt in this case had an eight and one-half month term, the debt in this case was long-term and the payments were recoverable

pay off previous investors." *In re Bullion Reserve of N. Am. (Danning v. Bozek)*, 836 F.2d 1214, 1219 n.8 (9th Cir. 1988).

[3] The Bank submitted extensive evidentiary objections to the hearsay declarations submitted by the trustee on the alleged Ponzi scheme issue. Because of the bankruptcy court's ruling on the legal issues, the bankruptcy court did not reach the evidentiary objections.

[4] The *CHG Int'l* decision was rendered after the Bank prevailed in the district court and the matter had been fully briefed in the court of appeals.

by the trustee. The Ninth Circuit expressly did not reach the trustee's second argument regarding the Ponzi scheme issue.

In the face of contrary decisions in several other circuits, this Court granted the Bank's Petition for Writ of Certiorari.

SUMMARY OF ARGUMENT

The preference statute of the Bankruptcy Code of 1978 employs a two-step process to determine whether a pre-petition payment made by the debtor in favor of a creditor is recoverable by the estate. Section 547(b) sets forth five criteria that must be met to establish that a preferential payment has been made, including that the payment was made on an antecedent debt within 90 days of the date of bankruptcy (for a non-insider) and that retention of the payment would allow the creditor to receive more than it would have otherwise received on its claim in a Chapter 7 liquidation of the debtor's assets.

Those payments that qualify as preferences under this test may nevertheless escape avoidance by the trustee if they come within one of several statutory exceptions. Section 547(c)(2), the "ordinary course of business" exception, protects payments (a) made on "a debt incurred by the debtor in the ordinary course of business or financial affairs," (b) made in the ordinary course of business or financial affairs of the debtor and the creditor, and (c) made in accordance with ordinary business terms.

Under the plain meaning of the statute's language, there is no basis for finding § 547(c)(2) applicable to short-term or trade debt but inapplicable to long-term debt. Neither the statutory definition of the term "debt" nor any other provision of the Code suggests any such distinction, though the Code contains other instances where Congress clearly distinguished between trade and other kinds of debt. Further, in 1984 Congress repealed

a provision in the original 1978 Bankruptcy Code which had limited § 547(c)(2) to payments on debts made within 45 days of the date the debt was incurred. In doing so, it rejected, because of dissatisfaction with its practical operation, precisely the type of requirement that the Ninth Circuit here found operative.

The legislative history fully supports the plain meaning of the statute's words. The 45-day limitation, in effect for only six years, was a departure from 80 years of prior practice under the Bankruptcy Act of 1898. Under the Act, avoidance of a preference turned on a showing that the creditor at the time of the payment had reasonable cause to believe that the debtor was insolvent, and contained no limit on the term of the debt. The Bankruptcy Code abandoned the "reasonable cause to believe" requirement in favor of an objective test for determining a preference, which included the limitation of the ordinary course exception to payments made within 45 days of the date the debt was incurred. As indicated by substantial testimony before Congress in the early 1980s, the provision was widely viewed as unsatisfactory because it did not reliably serve in practice to protect payments on debts made in the ordinary course of business. The 1984 repeal of the 45-day provision was intended to address that concern. Nothing in the legislative history suggests in any way that a residual limitation remained, confining the exception to debt of a particular term.

The policies behind the preference provisions also support the apparent meaning of the words of § 547(c)(2). The two general policies of the preference statute are to promote equality of distribution and to discourage unusual action by either the debtor or the creditor that might precipitate a race to dismember the debtor's assets during its financial decline. These policies are not undermined by the application of the statute according to its terms to both long-term and short-term debt.

The Ninth Circuit's judicially created limitation would not advance the policy of equality of distribution, since payments on short-term debt, no less than long-term debt, allow particular parties to get more than they would receive in a liquidation of the debtor's assets under Chapter 7. Further, such a limitation actually impairs the second policy of the preference statute—to discourage unusual action by the debtor or creditor that might speed the debtor's economic decline. It would penalize creditors who continue to carry on normal dealings with the debtor as its business declines and thereby exacerbate the unavailability of credit.

Only if the Court concludes that an unwritten limitation should be inferred by which payments on short-term debt alone are protected would the Court need to address the distinction between short- and long-term debt. If so, Petitioner submits that the one-year cutoff, dictated by generally accepted accounting principles and commercial practice, should be adopted to create legal certainty in the application of the exception.

ARGUMENT

I. BANKRUPTCY CODE § 547(c)(2), THE ORDINARY COURSE OF BUSINESS EXCEPTION TO THE PREFERENCE RULE, DOES NOT DISTINGUISH BETWEEN SHORT-TERM AND LONG-TERM DEBT.

A. The Statute Is Unambiguous and Its Plain Language Is Conclusive in This Case.

The interpretation of any statute must begin with the language of the statute itself. *Pennsylvania Dep't of Pub. Welfare v. Davenport*, 495 U.S. ——, 109 L. Ed. 2d 588, 595, 110 S. Ct. 2126 (1990). Absent exceptional circumstances, the plain meaning of the statute controls. *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571, 73 L. Ed. 2d 973, 102 S. Ct. 3245 (1982). In interpreting the Bankruptcy Code, this Court recently stated:

> The plain meaning of legislation should be conclusive, except in the "rare cases [in which] the literal ap-

plication of a statute will produce a result demonstrably at odds with the intentions of its drafters." [Citation omitted.]

United States v. Ron Pair Enter., Inc., 489 U.S. 235, 242, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989). *See also Toibb v. Radloff*, 59 U.S.L.W. 4633, 4634 (June 13, 1991) (in which the Court refused to infer a limitation on individuals eligible for protection under Chapter 11 by holding that "the plain language of the statute disposes of the question before us").

At issue is the proper interpretation of the phrase "a debt incurred by the debtor in the ordinary course of business or financial affairs." 11 U.S.C. § 547(c)(2). Specifically, the question is whether that exception is limited in a manner not stated in the statute to short-term or trade debt, as distinguished from long-term or other commercial obligations. Nothing in the statute supports such a reading.

The term "debt" is specifically defined in the Bankruptcy Code as "liability on a claim." 11 U.S.C. § 101 (12). It is not qualified in any other way. The original version of the Bankruptcy Code, as enacted in 1978, included a requirement within the ordinary course of business exception of § 547(c)(2) that the transfer at issue be "made not later than 45 days after such debt was incurred." The deletion of this provision in the Bankruptcy Amendments and Federal Judgeship Act of 1984 removed any limitation on the term of the debt excepted. *See* Pub. L. No. 98-533, 98 Stat. 333 (1984).

Other portions of the Code illustrate that Congress was familiar with different types of debt and capable of drawing distinctions among them. In fact, § 1304(a) of the 1978 Bankruptcy Code uses the term "trade credit" in a provision that permits a Chapter 13 debtor to incur such credit post-petition without court approval. *See also* 11 U.S.C. § 101(49)(b)(vii) (in which Congress excluded from the definition of security "debt or evidence of in-

debtedness for goods sold and delivered or services rendered").

The court below did not suggest that the language of the statute itself supports its interpretation, nor did the Ninth Circuit find that the language of the statute is ambiguous. In fact, the Ninth Circuit acknowledged that the "literal" application of the statute would make no distinction whatsoever among loans according to the duration of the loan or the character of the credit so long as the "ordinariness" standard was satisfied. *CHG Int'l*, 897 F.2d at 1484 ("a literal . . . reading of the new section 547(c)(2) appears to remove the primary obstacle which excluded these [long-term] loans from the exception").

The conclusion reached by the court below can only be justified on the obviously false assumption that the court knows better than Congress itself what Congress must have intended.[5] Faced with the identical issue presented here, the United States Court of Appeals for the Sixth Circuit found no distinction under § 547(c)(2) between short-term and long-term debt, *In re Finn (Gosch*

[5] The Ninth Circuit reasoned that ordinary course payments on trade debt should be protected for policy reasons (but payments on long-term debt should not) because those payments on trade debt do not diminish the estate and are not payments on an antecedent debt, and trade creditors "replenish" the estate by continuing to provide new goods and services to the debtor. *CHG Int'l*, 897 F.2d at 1483. The court's rationale ignores the other exceptions of the Code that protect from recovery "substantially contemporaneous" exchanges (§ 547(c)(1)) and preferential payments to the extent the creditor gives the debtor new goods, money or services after receiving the preference (§ 547(c)(4)). Thus, there are other exceptions to the preference statute that address the policy considerations cited by the Ninth Circuit. The ordinary course of business exception was designed to address different concerns: "to leave undisturbed normal financial relations" and to "discourage unusual action by either the debtor or his creditors." H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 Collier on Bankruptcy ch. II (15th ed. 1990).

v. Burns), 909 F.2d 903, 907-08 (6th Cir. 1990), and characterized the contrary view as

> import[ing] too much assumed history into the barren language of the statute. On its face, the pre-1984 language applied to all debt incurred "in the ordinary course," and the limitation came from requiring the payment within 45 days of the debt. By eliminating the 45-day limitation, and neither stating nor implying any other limitation, Congress's language left the field open to long-term consumer debt for exception under § 547(c)(2). Some courts take the position, as *In re Control Electric*, that without legislative history to back it up, a change in the language of the statute is not to be respected. . . . We reject this method of statutory interpretation.

The Ninth Circuit's failure to heed the words of the statute and the repeal of the 45-day limitation runs counter to this Court's clear admonition that "whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206, 99 L. Ed. 2d 169, 108 S. Ct. 968 (1988). The language is clear: it imposes no restriction on the type of debt that falls within the ordinary course of business exception; it does not refer to a limit on the term of the debt or set time periods for the date the debt was incurred and the date the payment was made. Any such time limitation was eliminated by Congress when it deleted the 45-day rule. It is improper for the judiciary to reimpose such a time limitation in the face of deliberate action by Congress to eliminate such a restriction.

B. The Plain Meaning of § 547(c)(2) Is Supported by the Legislative History.

The Bankruptcy Act of 1898 protected most ordinary-course payments against avoidance as a preference and did not distinguish between short- and long-term debt.

An analysis of the former law indicates that it was the 45-day limitation that radically departed from *80 years* of prior bankruptcy practice.

Section 60 of the Bankruptcy Act of 1898, as amended in 1938,[6] governed the recovery of preferences. Subsection (a) of § 60 set forth the tests for determining whether the transfer of property was preferential. If the trustee established that the transfer was preferential, the trustee was still required to prove that the transfer was recoverable by the estate by meeting the requirements of § 60(b), including a showing that the creditor benefited had, "at the time when the transfer [was] made, reasonable cause to believe that the debtor [was] insolvent."

Under the old Act, many preferential payments on both trade debt and long-term obligations were not recovered because of the difficult burden faced by the trustee to prove the state of mind of the creditor and his knowledge of the debtor's financial circumstances. *See, e.g.*, H.R. REP. NO. 595, 95th Cong., 1st Sess. 178-79 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990). In the Bankruptcy Reform Act of 1978, Congress endeavored to correct the problem of proof faced by the trustee under the old Act by eliminating the "reasonable cause to believe" requirement and creating a presumption of insolvency during the 90 days preceding the filing. H.R. REP. NO. 595 (95th Cong., 1st Sess. 178-79 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990).

In revamping the preference provisions of the Bankruptcy Act, the 1978 Code was restructured to state that all preferences are recoverable unless they meet one of several exceptions. One of those exceptions is § 547(c)(2). The House and Senate reports submitted in con-

[6] 11 U.S.C. § 96 (*repealed by* the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978)).

nection with the 1978 Bankruptcy Code include the following explanation of the purpose of the ordinary course of business exception:

> The purpose of this exception is to leave undisturbed normal financial relations, because it does not detract from the general policy of the preference section to discourage unusual action by either the debtor or his creditors during the debtor's slide into bankruptcy.

H.R. REP. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990); S. REP. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* App. 3 COLLIER ON BANKRUPTCY ch. V (15th ed. 1990).

The inference that the 1978 statute was intended to apply only to trade debt or other short-term debt arose from the provision of § 547(c)(2) limiting the protection to payments made within 45 days of the date the debt was incurred. The 45-day rule is not addressed specifically in the legislative history of the 1978 Code, and the rule had unintended consequences that were brought to Congress's attention in a series of hearings commencing in 1980 that culminated in the deletion of the rule in 1984.

During hearings conducted by the Senate beginning in 1980 to evaluate the operation of the new Bankruptcy Code, numerous scholars and practitioners criticized the operation of the 45-day rule. At Senate hearings on Senator DeConcini's bill to amend § 547(c) to include a special provision protecting payments made on commercial paper,[7] Professor Lawrence King, a noted bankruptcy scholar and member of the National Bankruptcy Conference, responded to questions regarding the proposed amendment. Professor King suggested that instead of taking a piecemeal approach to protect ordinary course

[7] S. 3023, 96th Cong., 2d Sess. (1980).

payments, "The whole section needs to be looked at. It just does not work," and that the reenactment to the reasonable cause to believe requirement "would solve a lot of problems." Hearing Before the Subcomm. on Judiical Machinery of the Senate Comm. on the Judiciary, 96th Cong., 2d Sess. 4 (1980) (statement of Lawrence King, Professor, School of Law, New York University).

In hearings conducted in 1981, various changes to the preference statute were suggested. The central theme was that regular payments made on debt in accordance with the terms of the credit arrangement should not be recoverable since preference exposure for such payments was disrupting normal financial relations and tightening the availability of credit. *See generally* Hearings Before the Subcomm. on Courts of the Senate Comm. on the Judiciary, 97th Cong., 1st Sess. 229-75, particularly 245, 259, 260 (1981) (hereinafter cited as "1981 Hearings").

For example, one witness testified that "the operation of preference litigation should not impair or impede normal commercial transactions," and that if it did, the "beneficial purposes may be outweighed by the damage they do in the real world of business and commerce." 1981 Hearings, at 254. The ordinary course of business exception "was not intended to change how people did business" according to another witness. 1981 Hearings, at 245.

Thereafter, the Senate introduced the Bankruptcy Improvements Act of 1981. The bill proposed to add back into the preference statute the "reasonable cause to believe" requirement from the former Bankruptcy Act. S. 2000; S. REP. No. 446, 97th Cong., 2d Sess. (1982). The report accompanying the bill evidences a specific intention that ordinary course of business payments on all types of debt that satisfy the "ordinariness" criteria not be recoverable. S. REP. No. 446, 97th Cong., 2d Sess. 24 (1982). The report's analysis of the specific sections of S. 2000 includes the following comments:

> The trustee retains the power to avoid liens and recover payments where a creditor knowingly applies last minute pressure on an insolvent debtor in the hope of obtaining more favorable treatment that [sic] the creditor would receive in bankruptcy. The amendment will permit regular payments, made voluntarily by the debtor in the ordinary course of business and prior to filing of the petition, to be retained by the creditor.
>
> . . . .
>
> The removal of the "reasonable cause to believe" requirement from the preference section in the 1978 act had unforeseen consequences in industries dependent upon installment credit payments.
>
> The amendment will restore the balance in the section and permit only those payments which are true preferences to be recovered.

S. REP. No. 446, 97th Cong., 2d Sess. 42-43 (1982).

Additional hearings on amendments to the Code were held in 1983,[8] in which there was further criticism of the disruptive effect of the 45-day rule on consumer lending transactions, particularly retail installment contracts.[9] Also during 1983, the Omnibus Bankruptcy Improvements Act of 1983 was introduced, not only reimposing the "reasonable cause to believe" requirement but also deleting the 45-day rule from § 547(c)(2). S. 445; S. REP. No. 65, 98th Cong., 1st Sess. 14 (1983) (report to accompany S. 445). Ultimately, the preference provisions of S. 445 were modified to omit the "reasonable cause to believe" requirement, among others, and were incorporated into and passed as part of the miscellaneous substantive and technical amendments of the Code in the Bankruptcy Amendments and Federal Judgeship Act ("BAFJA") of 1984. Congress implicitly decided not to reintroduce the "reasonable cause to believe" requirement for the same reasons that it had eliminated the requirement in 1978: to avoid litigation over the state of mind of the creditor as a condition to the avoidance of a preference. In eliminating the 45-day rule, however, the amendments as enacted returned creditors to the state of affairs under the Act, where the term of the debt was irrelevant in determining whether a preference was avoidable.

[8] No action was taken by the full Senate on proposed S. 2000 before the conclusion of the legislative term.

[9] *See* Exhibit 1 to April 6, 1983 Hearing Before the Senate Comm. on the Judiciary (*Report and Recommendation* by the Consumer Bankruptcy Subcomm. of the Comm. on Consumer Financial Services of the American Bar Ass'n Section on Corporation, Banking and Business Law). Retail installment contracts are long-term debts, and payments on those contracts would not be protected by the ordinary course of business exception because of the 45-day rule.

The reports accompanying both Omnibus bills indicate that Congress balanced the competing interests and the outcomes that would result from the amendment of the statute and found that it was more important to promote normalized business dealings with creditors than to increase the potential preferential payments that could be recovered in bankruptcy. S. Rep. No. 446, 97th Cong., 2d Sess. 24 (1982); S. Rep. No. 65, 98th Cong., 1st Sess. 13-14 (1983). Nothing in the legislative history of § 547(c)(2) suggests that Congress intended to exclude from the protections of that statute any particular class of creditor whose debt and the payments thereon otherwise meet the statutory criteria of the amended statute.

C. The Policies of the Preference Provisions Also Support the Plain Meaning of the Statute.

The preference provisions of the Bankruptcy Code were designed to promote two general policies: (1) equality of distribution among similar classes of creditors; and (2) discouragement of unusual action by creditors that might prompt a race to the courthouse and dismemberment of a debtor's assets. *See, e.g.*, H.R. REP. No. 595, 95th Cong., 1st Sess. 177-78 (1977), *reprinted in* App. 2 COLLIER ON BANKRUPTCY ch. II (15th ed. 1990).

The first policy—equality of distribution—is theoretically achieved by returning to the estate payments that creditors received from the debtor's assets that would otherwise allow those creditors to receive more than they would have received in a Chapter 7 liquidation. However, Congress determined that certain admittedly preferential payments, which by definition should be returned to the estate under this rule, need not be recovered for policy reasons. The equality of distribution principle provides no basis for distinction between payments on short-term and long-term debt made during the preference period since both deplete the estate to the same degree.

The second policy—discouragement of unusual action by creditors—is achieved by constructing a statute which does not penalize creditors that continue their regular financial dealings with the debtor. In that regard, a rule that discriminates against the long-term lender only restricts the availability of credit (*see* 1981 Hearings, at 259) and provides an incentive for the lender to assert financial covenant defaults under its loan documents at the first sign of a debtor's financial distress. Even if depletion of the estate were the paramount concern of § 547(c)(2), the Ninth Circuit's rule does not better protect the estate against depletion than does the contrary rule. Treating short-term and long-term debt the same would encourage all creditors to continue to deal with the debtor under their normal loan terms without threat of preference exposure, thereby providing the debtor the benefit of the loan proceeds during its period of financial distress.

Under the Ninth Circuit's interpretation of the statute, if the lender were to continue to accept regular payments, the lender would suffer a double penalty: any payments made to the lender during the debtor's slide into bankruptcy would be recovered as preferential and the debtor could use the working capital and limited as-

sets of the business to pay trade creditors who would be entitled to retain any ordinary course payments made during that time frame, thus reducing the assets available to pay the lender's claim. The Ninth Circuit's interpretation of the statute undermines rather than promotes the goal of encouraging creditors to continue their normal financial dealings with the debtor during its financial difficulties and would ultimately result in the cutoff of ordinary course payments to trade creditors as long-term loans are called and the debtor is forced into bankruptcy prematurely.

While the Ninth Circuit recognized that Congress intended to protect payments made on commercial paper when it eliminated the 45-day rule (*CHG Int'l*, 897 F.2 at 1484), the court ignored the role that commercial paper plays in the financial operations of a business. Commercial paper is an alternative source of financing used by business to obtain working capital, just as the revolving line of credit provided by the Bank to the debtor in this case was designed to provide working capital for the debtor's operations. In effect, it is the capital from non-trade credit that provides the financial base for a business and permits a debtor to make ordinary course payments to its trade creditors. There is no basis in the policies behind the Code for inferring that Congress found the role long-term credit plays in a debtor's business to be less vital or less worthy of protection than trade credit or commercial paper when Congress eliminated the 45-day rule.

II. IF THE COURT RULES THAT § 547(c)(2) APPLIES ONLY TO SHORT-TERM DEBT, THEN A DEFINITION OF LONG-TERM DEBT SHOULD BE RECOGNIZED THAT ACCORDS WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND BUSINESS PRACTICES.

The Ninth Circuit in *CHG Int'l* ruled that "long-term" debt is not protected under the ordinary course of business exception. In *ZZZZ Best*, the Ninth Circuit ruled

by negative implication that because the loan in this case had a term longer than the loan held to be "long-term" in *CHG Int'l,* the payments to the Bank in this case were on long-term debt and were not exempt from recovery under § 547(c)(2). Unfortunately, the Ninth Circuit left the commercial world to guess as to the exact definition of short-term debt it was employing. Failure to follow the plain meaning of the statute would leave courts with the task of distinguishing between long-term debt and short-term debt with nothing in the Code to guide their determination.[10]

To avoid uncertainty, this Court should make reference to generally accepted accounting principles and commercial realities. Accounting standards accepted by the Internal Revenue Service and implemented in business practice provide that obligations with a term of less than one year be deemed short-term, current liabilities. RESTATEMENT AND REVISION OF ACCOUNTING RESEARCH BULLETINS, Accounting Research Bulletin No. 43, ch. 3 "Working Capital," § A7 (Am. Inst. of Certified Pub. Accountants 1953); S. Stern, *Structuring Commercial Loan Agreements* ¶ 6.03[1][b] (2d ed. 1990) (WG&L). A bright line test defining long-term debt to be debt of one year or longer would meet with general expectations in the business community, would provide a test that is

[10] The Ninth Circuit could have distinguished between repayment of the principal of long-term debt and payment of monthly interest on the debt as the Eighth Circuit did in *In re Iowa Premium Serv. Co., Inc. (Iowa Premium Serv. Co., Inc. v. First Nat'l Bank in St. Louis, etc.*, 695 F.2d 1109 (8th Cir. 1982). In *Iowa Premium,* the Eighth Circuit held that monthly interest payments on debt constitute payments on a short-term obligation incurred within 45 days of the date the debt was incurred. The Ninth Circuit rejected the *Iowa Premium* holding. *CHG Int'l,* 897 F.2d at 1486. If the Court rejects the plain meaning of the statute, courts will also have to struggle with the concept of whether the payment of interest is distinct from the repayment of the principal and whether the debt for interest is "short-term" even if the underlying loan is "long-term."

practical and easily implemented, and would avoid wasteful litigation into the issue whether the debt in a particular case is or is not long-term.

CONCLUSION

Neither the plain language of the statute nor the policies and purposes of the statute as reflected in the legislative history provide a basis for limiting the ordinary course of business exception of § 547(c)(2) to particular types of debt so long as the debt satisfies the criteria of the statute for "ordinariness." The holding of the Ninth Circuit that payments on long-term debt are not within the scope of § 547(c)(2) should be reversed.

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